—IN THE—

United States Circuit Court of Appeals

For the Ninth Circuit

STOCKGROWERS STATE BANK OF MOUNTAIN HOME, a Corporation, and THE FIRST NATIONAL BANK OF MOUNTAIN HOME, a Corporation,

Appellants

vs.

CHARLES E. CORKER, Trustee of the Estate of Thomas Trathen, a Bankrupt,

Appellee.

APPELLEE'S BRIEF

Upon appeal from the United States District Court for the District of Idaho, Southern Division

HARRY S. KESSLER,
W. C. HOWIE,
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STATEMENT OF THE CASE.

This action was instituted by appellee as trustee in bankruptcy to recover from the appellants for the benefit of creditors of the bankrupt estate the possession of, or in lieu thereof, the value of the stock of furniture and the notes and accounts which constituted the entire estate of one Thomas Trathen, the bankrupt. The trial Court, af-

ter hearing the evidence, entered its decree (p. 23) to the effect that the chattel mortgage and the foreclosure proceedings thereunder taken by the Stockgrowers State Bank, one of the appellants, created a voidable preference, and ordered the defendant to redeliver the property to the plaintiff within twenty days of the date of the decree, and if it should not be so re-delivered that plaintiff should have judgment therefore in the sum of $2465.18, which was found to be the value of the property.

We agree with counsel for appellant in their statement that "there is no serious dispute as to the facts," but a fuller statement of the facts than set forth in their brief will mar the picture of innocence that their narration of the transaction portrays.

Mountain Home, Idaho, the place where the events occurred that led to this controversy, is a country town in which there was located at that time but two furniture stores and two banks. These two banks, the appellants here, seemed to have caught the financial spirit of the age. R. B. Chattin, president of the First National Bank, was a director in the Stockgrowers Bank. Will T. Montgomery, assistant cashier of the First National Bank, was also a director in the Stockgrowers Bank, and R. W. Smith, the vice president of the Stockgrowers Bank, was an active stockholder, although not an officer, in the First National Bank, and Mr. L. B. Green was the attorney for both banks. The particular activity of these four men throughout the transaction, as disclosed by the evidence, should be noted.

Mr. Trathen, the bankrupt, had been in the furniture business at Mountain Home for a number of years and

had been doing his banking with the First National Bank prior to July 13th, 1911. The other furniture store, to-wit, the Thompson Furniture Company, of which Mr. G. W. Herder was manager had been doing its banking business with the Stockgrowers Bank prior to July 13th, 1911. Both of these furniture houses were rather heavily indebted to their respective banks. Mr. Trathen owed the First National two notes, one for Seventeen Hundred Dollars ($1700), very doubtfully secured, and one for Five Hundred Dollars ($500), and there was some accrued interest on both. The Thompson Furniture Co. was indebted to the Stockgrowers State Bank on an unsecured note for $3400.00, and interest, besides a little overdraft. Business conditions with Mr. Trathen were not satisfactory at that time, and Mr. E. M. Wolfe, another attorney of the town, received for collection from certain creditors of Mr. Trathen various claims, which amounted to something over $800.00. Mr. Wolfe was pressing these claims for collection and Mr. Trathen, in order to satisfy the demands of Mr. Wolfe, went to his bank, the First National, and applied for an additional loan. Mr. Austin, cashier of the First National Bank testified as follows (pp. 31-32):

> "He wanted more money to take up some of these sight drafts to put his business in better condition. * * * In a general way I discussed with the officers and directors of my bank the fact that Trathen wanted more money and merely in a general way called attention to the facts these drafts were out. Mr. Chattin was one of the directors to whom I spoke. I considered the Trathen account unsatisfactory because I had made demands for accrued interest and it was not forthcoming. I imagine I had investigated his assets and knew practically what they consisted of. I pre-

sume I advised the board of directors as to what his property consisted of, though I cannot say positively."

Mr. L. B. Green, the attorney for both banks, in testifying as to what occurred after Mr. Trathen made his application for an additional loan, said (p. 47):

"There was a meeting of the directors of the First National and Mr. Chattin phoned me to come down and I think instructed me to prepare notes and mortgages to include the Trathen debt at that bank and some debts Mr. Wolfe had. I went with Mr. Trathen to get the amount of these debts when the cashier told me I need not draw the papers, and I did not. I think Mr. Chattin was the next one who spoke to me about the matter. He said he was trying to get the loan for Trathen at the Stockgrowers' State Bank, and it may have been three or four days after that when he told me to draw the papers for the Stockgrowers State Bank and to cover the amount of the debts Wolfe had and that held by the First National."

It thus appears that the First National Bank had decided to make the additional loan and instructed its attorney to prepare the papers and then afterwards fell upon a new plan. For some reason not explained, and after several days of deliberation, the unique plan was evolved of switching the accounts of the two furniture houses. Accordingly, in the language of Mr. Herder, the manager of the Thompson Furniture Co. (pp. 32-33):

"The Stockgrowers Bank called the loan and I got the money from the other bank to pay them by a loan secured by a mortgage. I did not have the ready money to meet the Stockgrowers' loan, and in looking around for another loan, Mr. Montgomery suggested that I might, or could, get it from the First National Bank, and I took it up with Montgomery and

> Chattin and the bank gave me the loan. I gave additional security and the Stockgorwers' loan was paid that way. Mr. Montgomery suggested to me that I could get this loan in my place of business, and then I met Montgomery and Chattin and one or two other officers of the bank. I was called in by them after I had been talking with Montgomery. Montgomery, Chattin and Ake were in there part of the time, and also Roscoe Smith. Montgomery did most of the talking, stating that the Stockgrowers wanted the loan paid and that the First National would give me the money. Mr. Smith informed me that they could not any longer carry me. * * * I believe Chattin and Montgomery did the talking principally. * * * Montgomery was the first man who suggested my getting the loan at the First National Bank."

It thus appears that the Thompson Furniture Co., although in no particular financial difficulty, was notified that it must settle its account with the Stockgrowers State Bank, and concurrently with this demand was the suggestion that the First National Bank would supply its needs. Mr. Trathen in turn was notified that his application for an additional loan made at the First National Bank had been denied, but he was also notified at the same time that the Stockgrowers Bank would furnish him the necessary money. Mr. Trathen did not make application for a loan to the Stockgrowers State Bank. As a result of this pre-arranged plan, carried out principally by the three men above named, that were jointly active in both banks, and Mr. Green, the attorney for the two banks, the necessary papers were drawn and notes and chattel mortgages were executed by both furniture houses to the respective banks designated by the jointly interested committee. Each furniture house gave its new note secured by a chat-

tel mortgage on its entire assets to its new involuntarily selected bank. These papers were all executed on July 13th, 1911. It appears, however, that the accounts were not transferred on the books of the banks until about three weeks later, but nevertheless the switch was made on the same day, to-wit, August 5th, 1911.

It also appears that over two years before this eventful 13th day of July, 1911, Mr. Trathen borrowed $1700.00 from the First National Bank, furnished two endorsers, to-wit: W. D. Evans and John Owens. These endorsers, to secure themselves, in April, 1909, took a mortgage on the Trathen stock of furniture. This mortgage was never renewed and no steps were ever taken by the mortgagees to exercise any rights under it. But on the 13th day of June, just one month prior to the interesting transaction of July 13th, this mortgage for some peculiar reason was assigned by the mortgagees to the First National Bank (testimony of Mr. Trathen, p. 39). This is significant, as suggesting that there was some contemplation of financial difficulty at that time. Furthermore, Mr. Trathen, during the several years that he was banking at the First National Bank had furnished various statements in writing of his financial condition. The last statement that appellants introduced enumerating his assets and liabilities was given January 12th, 1910 (p. 42). Earlier statements are set forth on pages 49 and 50. Mr. Trathen testified (p. 39):

> "I don't know as any exact inventory was taken at the time of giving the mortgage. I think somewhere about a month or two before that time I did make a statement to the bank as nearly as I can get at it as to what the inventory did amount to."

If this statement referred to by Mr. Trathen was in writing it was not produced, for some reason, by appellants. It will be noted that the three statements introduced by appellants do not materially differ. They all show that the home was too heavily mortgaged to be available as an asset. The furniture, valued at $2000.00 and $2200.00, was exempt, and the merchandise indebtedness was 50 per cent of the inventory, which to an experienced business man is known to be about the full value of an old stock. The only other assets listed are the Sunnyside water right and the Great Western note and some book accounts. The Great Western notes were conditional upon the completion of the segregation of an irrigation project, which was an apparent failure long before July, 1911 (pp. 43-44). The desert entry and water rights thereunder never had any other than a speculative value. (See testimony of Mr. Norrell, pp. 45-46). The officers in both banks were acquainted with the fact that Mr. Wolfe had a list of accounts and was pressing them for collection. The note and mortgage given to the Stockholders State Bank covered not only the amount Trathen was owing the First National Bank, but also the amount of Mr. Wolfe's accounts. Mr. Wolfe receipted the accounts, although he never received anything for his clients.

After this mortgage was given, Mr. Trathen kept the store open and made daily sales and purchases in the ordinary course of business, but never at any time accounted to the mortgagee for such daily sales as required by the mortgage. About sixty days after this mortgage was given, the Stockgrowers Bank proceeded to foreclose, and on October 2d the sheriff sold the stock and the Stock-

growers State Bank bid it in for $2465.18, the inventory value. On October 23d following, Mr. Trathen was adjudged a bankrupt, and the appellee, Mr. Corker, was elected trustee. He made demand for the possession of this stock. The Stockgrowers State Bank referred him to their attorney, Mr. Green, and when he saw Mr. Green regarding it, he was advised that the bank had the property storing it, "waiting for somebody to raise a rough house" (p. 29). It clearly appears that Mr. Trathen was bankrupt on and for a considerable time prior to July 13th and that there are no assets available for other creditors of the bankrupt estate unless the execution sale is set aside.

RECORD CORRECTED.

The error in printing the record originally referred to on page 8 of the appellant's brief, has been corrected by reprinting pages 29, 30, 30a and 30b, and eliminating pages 51 and 52 of the record as originally printed.

ARGUMENT.

Counsel for appellant seem to base their claim for a reversal of the judgment largely on the ground that the First National Bank was secured at least to the extent of $1700.00 through their right of subrogation under the Evans and Owens mortgage, which was executed in April, 1909. Our reply, however, is that that mortgage was of no value as security to the First National Bank for two reasons. In the first place, this mortgage was executed two years and three months prior to July 13th, 1911, on a stock of merchandise that was being disposed of daily, in

the ordinary course of business, and being replenished as necessary from time to time to keep the stock at its normal value. The mortgage did not and could not have legally covered the after acquired stock. There is nothing in the evidence to show what portion of the stock originally mortgaged remained in the store on July 13th, and there is no apparent way by which the mortgagees or the First National Bank could have selected the original stock if any remained, so that Evans and Owens in fact had no security on the date in question (Ryan vs. Rogers, 14 Idaho, 309, 94 Pac. 427). And secondly, the Evans and Owens mortgage made no provision for the application of the proceeds of the sales to the mortgage indebtedness, and was therefore void as to creditors. It is probably true as between the mortgagor and the mortgagee such a mortgage was valid as to such stock that it actually covered, and such mortgage might have become valid as against creditors by the taking possession by the mortgagees. But possession under that mortgage was never at any time taken, so that so far as the rights of creditors are concerned that old mortgage never was of any force and effect and never became a lien superior to or ahead of the rights of other creditors. We, therefore, submit that when counsel declare that the strength of the position of the First National Bank is based on this mortgage they have, indeed, laid their foundation on shifting sand. The rights under this mortgage must be determined by the laws of the State of Idaho, and the case of Ryan vs. Rogers, supra, we believe thoroughly disposes of their contention in that regard. It will be noted that in the case just cited a trustee in bankruptcy was the plaintiff in the action against the

sheriff, who was holding the stock of merchandise by virtue of possession secured under a chattel mortgage. In the opinion on re-hearing, Justice Sullivan, in quoting from the Supreme Court of Montana in reference to a mortgage on a stock of merchandise which was being sold in the ordinary course of business long after maturity, said that a mortgage under such facts and circumstances "becomes a mere sham, a mere appearance, a delusion asserting in form what is not a fact." We would suggest to counsel in their own language, that it is of the utmost importance to a correct understanding of the situation to realize the *weakness* of the position of the First National Bank at that time, and to view its subsequent action and to judge its motives from that standpoint. The fact that the bank took an assignment of this old mortgage on June 13th, 1911, forcibly suggests that possibly they intended to exercise for their protection some contemplated right of possession thereunder which they later concluded to be worthless.

We wish to correct counsel's statement on page 10 of their brief that application was made to the Stockgrowers Bank. The record discloses that Mr. Trathen made application only to the First National Bank for the additional loan and went into detail with that bank as to his finances, and in his own words, this is what happened (p. 53):

> "I think two or three days afterwards Green notified me that I was wanted at the Stockgrowers State and I went there, but they were busy and did not want me just then. They notified me that Mr. Green would attend to the business, and the loan would be granted and the Stockgrowers State Bank would take up the

mortgage in place of the—and take up the First National account."

REASONABLE CAUSE TO BELIEVE

We have no quarrel with the authorities cited by counsel defining what is meant by "reasonable cause to believe" as used in Section 60-b of the Bankruptcy Act as amended by the Act of June 25th, 1910, except that the cases cited omit the one feature of the rule that is particularly applicable to the facts in this case. I refer to the idea of constructive notice. Loveland on Bankruptcy, Section 508, page 1010, states the law thus:

> "Constructive notice is sufficient, upon the ground that when a party is about to perform an act by which he has reason to believe that the rights of a third party may be affected, an inquiry as to the facts is a moral duty and diligence an act of justice. Whatever fairly puts a party upon inquiry is sufficient notice where the means of knowledge are at hand and if the party under such circumstances omits to inquire and proceeds to receive the transfer or conveyance, he does so at his peril, as he is chargeable of knowledge and of all the facts which by a proper inquiry he might have ascertained * * * The plea of ignorance on the part of the creditor will not relieve him of liability when a small amount of inquiry would have given all the necessary information."

Or, as stated by the Supreme Court of Minnesota in the case of Galbraith vs. Whitaker, 119 Minn. 447, 138 N. W. 772, 43 L. R. A. (N. S.) 427:

> "The rule is that facts which are sufficient to put an ordinarily prudent man upon inquiry as to his debtor's solvency charge such person, when they come to his notice, with all the knowledge he could have acquired

by the exercise of reasonable diligence. McElvain v. Hardesty, 94 C. C. A. 399, 169 Fed. 31."

"A creditor who receives a transfer from a bankrupt with knowledge that he was unable to pay his debts and had abandoned his business is chargeable with knowledge of all the facts which by a proper inquiry he might have ascertained."

Russell's Trustee vs. Mayfield Lbr. Co. (Ky. Court of Appeals, March, 1914). 32 Am. B. R. 357.

"It is sufficient if the circumstances are such as would lead an ordinary man to the conclusion that his debtor is insolvent."

Rogers vs. American Halibut Co. (Mass. Sup. Jud. Ct.) 31 Am. B. R. 576.

See also Batchilder vs. Home National Bank of Milford. (Mass. Sup. Jud. Ct. June, 1914) 32 Am. B. R. 555.

"The Circuit Court of Appeals will not disturb a judgment of the District Court unless it is overborne by the clear weight of the evidence as disclosed by the record."

Carey vs. Donahue (U. S. Circuit Ct. of Appeals Sixth Circuit) 31 Am. B. R. 210; 209 Fed. Rep. 328.

See also Eau Claire Nat. Bank vs. Jackman, 204 U. S. 522, 51 Law. Ed. 596.

We urge that the appellants in this case when the mortgage was executed on July 13th, 1911, not only had reasonable cause to believe that the defendant was insolvent and that this mortgage would give them a greater percentage on their debt than other creditors, but also that the only reasonable conclusion from the evidence is that

they positively knew that Mr. Trathen was insolvent and that this transfer would act as a preference. It must be born in mind that the original $1700.00 loan had been carried twenty-seven months and had not only not been reduced, but an additional $500.00 had been borrowed. The cashier had made demands for interest that had not been met. The bank had kept itself posted as to Trathen's financial conditions by repeated statements. According to Mr. Trathen, one of these was furnished only a month or two before the date in question. It does not appear that any of these statements were false except as to the estimated value placed on the several assets enumerated. The officers of the bank must have known the actual value of the several items specified. Referring to the statement of January 1st, 1910, as business men, they knew that the stock of furniture was actually not worth near the inventoried value. The figures show that the house was encumbered for practically all it was worth, and living in a small town, the bank undoubtedly knew that one of the mortgages on the house had been foreclosed and that it had been sold by the sheriff under foreclosure on April 7th, 1911. They knew the value of the two lots listed and may or may not have known that the title was imperfect. They knew the household furniture was exempt and could not be considered as an asset. They must have known the Great Western Sugar Co. note was valueless and that the Sunnyside project, under which the water rights were listed, was defunct. They knew that Trathen was owing them about $2300.00 and that Mr. Wolfe had $800.00 in claims, so if they made any calculation as to the assets and liabilities they could not have determined oth-

erwise than that Mr. Trathen was insolvent. That they had made such calculation must be assumed when they were interested to the extent of $2300.00 and without security. That they were worried about the position they were in is indicated by the fact that they secured an assignment of the Evans and Owens worthless mortgage only a month before. That drafts were coming in for payment of merchandise and were not being honored and that Attorney Wolfe was demanding payment of various claims which Mr. Trathen could not meet must have excited their interest, and when an application was made for a further loan to meet these demands as reasonable business men they could not have done otherwise than to make a sufficient investigation to become acquainted with the actual condition. In fact, Mr. Austin, the cashier of the First National Bank, hesitatingly admitted (p. 32):

> "I imagine I had investigated his assets and knew practically what they consisted of. I presume I advised the board of directors as to what his property consisted of, though I cannot say positively."

Mr. Chattin is particularly named as one of the several directors to whom Mr. Austin spoke about the drafts being out, and the unsatisfactory condition of the account. So we submit that these directors of the First National Bank knew of the insolvency of Mr. Trathen or at least if they didn't know it in fact they were acquainted with sufficient facts to put any reasonably prudent body of men on inquiry.

Furthermore, if they didn't know the actual conditions or have reasonable cause to believe that Trathen was insolvent, why did they switch the accounts of the two fur-

niture houses That was an act most unusual. It certainly was not done except for a purpose, and appellants certainly make no satisfactory explanation. The reasonable inference must be that they thought by doing so the loan of the Stockgrowers Bank might be classed as an advance for a present consideration rather than as a settlement of a pre-existing debt. Then there is another significant fact. After the foreclosure proceedings, the Stockgrowers State Bank did not attempt to convert their purchase into cash, but held the stock, and when served with notice by the trustee, their attorney promptly replied that "they had the property up there storing it waiting for some one to raise a rough house." Thus indicating that they had deliberately, but not with much confidence, attempted to fortify themselves and were expecting an attack from the trustee.

II.

In the second division of counsel's argument, they suggest that even if your Honors should conclude that there was collusion between the banks yet even in that event the Stockgrowers Bank would in reality become the agent of the First National and that this new mortgage would, therefore, be but a renewal of the old Evans and Owens mortgage. This is a most unusual position, indeed. They urge that even if you should find that these two banks conspired together to defraud the creditors and failed in their effort to defraud that nevertheless the Court would come to the rescue of the guilty parties and protect them by restoring them to the position held before the fraud was attempted. The further answer to this contention is the one pointed out in the beginning of our argument that

this old mortgage was worthless as security; first, because the stock originally mortgaged had largely been disposed of in the course of business, and, second, because the mortgage was void as to creditors in not making provision for the application of the proceeds to the mortgage indebtedness.

III.

The contention urged in part three of counsel's argument has, we believe, been clearly disposed of in the first paragraphs of this argument. They seem to intimate that because the property had been seized by the sheriff that such possession cured the defect in the mortgage and shut out the rights of creditors. That might be true in the case of an attachment under the State law, but not so in bankruptcy. The very purpose of Section 60-b is to enable creditors to set aside all such liens or transfers made within four months.

IV.

Their final contention is there was practically no diminution of the estate by giving the mortgage, and therefore no voidable preference. This contention is based on an erroneous premise that the original Evans and Owens mortgage covered the after acquired stock and was a valid lien on the entire stock of merchandise as it existed on July 13th, 1911. We have herein already several times pointed out, that that position is clearly untenable. We, threfore, ask that the decree be affirmed.

Respectfully submitted,

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HARRY S. KESSLER,

Appellee's Solicitors.